# FM encourages start-ups with cash flow relief for employees

## Now, they can take the risk of joining without having to pay taxes on Esops immediately

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*For quite some time, employees of start-ups have complained about a provision in the income-tax law that caused them hardship. Stock options are taxed in their hands as perquisite at the time of exercising (allotment), creating a liquidity problem for them. In Budget 2020, finance minister Nirmala Sitharaman has announced that the time when start-up employees will have to pay tax on their allotted stocks can be deferred. While their liquidity problems have been taken care of, youngsters joining start-ups need to pay heed to the risks they run when they participate in an employee stock option plan.*

**Tax liability deferred:** ESOPs are currently taxed first at the time of exercise of shares. The difference between their fair market value (FMV) on the date of exercise and the exercise price is taxed as perquisite. The employer deducts tax at source. Esops are also taxed at the time of sale of shares. The employee's capital gain gets taxed, the amount being the difference between the sale price and the FMV (on date of exercise).

Now, for employees of specified start-ups, the payment can be deferred. The tax can now be paid not at the time of allotment, but whenever one of three events occurs first: One, the date the employee leaves the company; two, when the share is sold; or three, after five years from the financial year in which it was exercised. The tax rate that applies will be of the year in which the option was exercised.

### WHO CAN AVAIL OF THIS CHANGE?

- Should be an eligible start-up according to Section 80-IAC
- Should have been incorporated after April 1, 2016 but before April 1, 2021
- Turnover should not exceed ₹100 crore
- Should hold a certificate from the Inter-Ministerial Board of Certification

At the time of allotment, the employee only gets shares, not hard cash. "Start-up employees faced hardship because while a tax liability arose at the time of allotment of shares, there was no monetary gain for them to pay the tax. The proposed change will help them deal with their cash flow issues," says Shalini Jain, tax partner, people advisory services, EY India. Employees will also benefit if they have moved into a higher tax bracket. "You will pay tax at the rate that applied to you when the shares were allotted," says Homi Mistry, partner, Deloitte India.

This benefit will only be provided only to start-ups that meet certain criteria (*see box*). "Ideally, it should have been provided to a wider range of start-ups," says Jain.

Next, let us turn to some of risks employees opting for Esops run.

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**Valuation risk:** This is the biggest one. "Employees give up on something tangible — the cash component in their salary — based on the belief in their ability to contribute to the company's growth story. But while opting for Esops, it is impossible to tell which side valuation will tilt," says Winnie Shekhar, partner, IndusLaw.

If the valuation declines between the time of exercise and that of sale, the employee could end up over paying tax. "Defer exercising your options until you are close to the sale of shares," says Rupali Singhania, Partner, Areete Consultants LLP.

Opt for Esops based on your age and risk-taking ability. "Somebody in his 20s can take greater risk than someone in 40s or 50s. Older people also have more obligations. They should opt for a bigger cash component in their salary," says Mistry.

**Liquidity risk:** Start-ups are unlisted, so there is no ready market for their shares. Employees can only exit at the time of IPO, if the company is acquired by a new investor, or if it does a buyback.

Check the Esop agreement closely: When an acquisition take place, will employees will be treated at par with promoters? "Sometimes, promoters are able to encash their shares while employees are not given the same opportunity," says Singhania. Study the Esop plan for exit options. Some companies set up trusts to buy back shares, which provides comfort that employees will be able to sell shares in an emergency.

**Know the vesting schedule:** Employees could lose their shares if they do not spend their entire vesting period (the time after which they acquire a right over the shares) with the company. Suppose that the vesting period is four years and 10 per cent of Esops vest in the first year, 20 per cent in the second, 30 per cent in the third, and 40 per cent in the fourth. The bigger tranches vest later on. If an employee quits early, he would forfeit those shares.

Employees are given time to exercise vested shares. "The exercise period is shortened to 60-90 days from the date of leaving the company, if employees quit. Be aware of such conditions or else you could lose out," says Singhania.